FOREIGN POLICY REPORTS

June 15, 1937

Hot Money: An International Problem

BY HERBERT M. BRATTER

PUBLISHED TWICE A MONTH BY THE

Foreign Policy Association, Incorporated

EIGHT WEST FORTIETH STREET, NEW YORK, N. Y.

VOLUME XIII NUMBER 7 *25¢ a copy* *$5.00 a year*

Hot Money: An International Problem

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with the aid of the Research Staff of the Foreign Policy Association

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SINCE early 1933 a great change has taken place in this country's attitude toward money and prices. Then the United States was in the midst of the depression; prices were low; people demanded inflation. Now we are recovering. Already we have experienced a considerable rise in prices of stocks and commodities. Comments are heard once more about the "cost of living." Washington is becoming "inflation conscious" and has begun to test the brakes.

Under the circumstances the country is made uneasy by the realization that for three years a heavy inflow of foreign capital has been expanding our bank deposits, increasing our excessive credit base, and boosting stock prices. There is no way of knowing when the movement will end, how long this capital will stay with us, how it will be employed while here, or when and under what circumstances it may leave. This restless migration of "hot money," as President Roosevelt recently called it, confronts us with a problem which has so far defied solution.

We do not want interest rates to be too easy or too tight. We are trying to control our price level. Perhaps, to some extent we can do this. But we seem unable to control this uninvited foreign capital which, on the way in, tends to accentuate the danger of inflation and on the way out might cause even more serious disturbances in our markets.

SHRINKING CREDITOR POSITION OF THE U. S.[1]

Before examining the current situation, it is well to review briefly the debtor and creditor history of the United States during the last few decades.

Since large amounts of European capital had been used in developing this country, the outbreak of the European war in 1914 found us heavily in Europe's debt. Large amounts of American securities were held in Britain and on the Continent. The World War altered this relationship. When the Armistice was concluded, Europe was our debtor.

After the war we continued to lend abroad and thus increase our net creditor position. Since 1934, however, foreign money has again been coming here in volume. Through foreign defaults, through sinking-fund purchases of foreign securities, and through new foreign investments in the United States our creditor position is rapidly melting away.

On the outbreak of the World War in 1914 large amounts of foreign-owned American securities, chiefly railroad stocks and bonds, were sold here to help finance war purchases. In all, the total resale of American securities by Europe during the war amounted to about two billion dollars.[2] Moreover, the peculiar position occupied by the United States from 1914 to 1918 resulted in a vast increase of commodity exports and a record-breaking "favorable" balance of trade. This was financed in part by large private loans to foreigners and, later, by prodigious direct advances by the United States government to foreign governments, following this country's entry into the conflict in April 1917.

Total publicly offered foreign issues taken by our investors, after allowance for refunding, have been officially estimated at over two billion dollars for the three years preceding our entry into the war.[3] During this same period there were also important new American direct investments abroad, but un-

1. Cf. John T. Madden, Marcus Nadler and Harry C. Sauvain, *America's Experience as a Creditor Nation* (New York, Prentice-Hall, 1937).

2. Cf. Charles J. Bullock, John H. Williams and Rufus S. Tucker, "The Balance of Trade of the United States," *Review of Economic Statistics,* July 1919, p. 246.

3. U. S., Department of Commerce, "American Underwriting of Foreign Securities in 1930," by Paul D. Dickens, *Trade Information Bulletin No. 746* (Washington, 1931), p. 9.

FOREIGN POLICY REPORTS, VOLUME XIII, NUMBER 7, JUNE 15, 1937

Published twice a month by the FOREIGN POLICY ASSOCIATION, Incorporated, 8 West 40th Street, New York, N. Y., U.S.A. RAYMOND LESLIE BUELL, *President;* WILLIAM T. STONE, *Vice President and Washington representative;* VERA MICHELES DEAN, *Editor;* HELEN TERRY, *Assistant Editor. Research Associates:* T. A. BISSON, VERA MICHELES DEAN, HELEN FISHER, HELEN H. MOORHEAD, DAVID H. POPPER, ONA K. D. RINGWOOD, CHARLES A. THOMSON, JOHN C. DEWILDE. Subscription Rates: $5.00 a year; to F.P.A. members $3.00; single copies 25 cents. Entered as second-class matter on March 31, 1931 at the post office at New York, N. Y., under the Act of March 3, 1879.

fortunately no estimate of the amount is available. We may summarize the events of the war years as follows:

	in millions
At the outbreak of the war we owed foreigners for their long-term investments in the United States about	$5,000*
Excluding direct investments, foreigners owed us for our long-term investments abroad approximately	2,350†
On balance, therefore, we were a *debtor* country to the extent of about	$2,650
During the war American securities resold to us by foreigners totaled approximately	$2,000
Loans publicly floated in the United States from 1914 to 1918, inclusive, totaled‡	2,707
American direct investments made abroad —amount unknown but not large	
Foreign direct investments in the United States taken over by the Alien Property Custodian had a value of	666§
American government loans to foreign governments through 1918 totaled‖	7,428
Total addition to our credit abroad	$12,801
Net *creditor* position of the United States at end of 1918	$10,151

*Ralph A. Young, *The International Financial Position of the United States* (New York, National Industrial Conference Board, 1929), pp. 27-28. The estimates here cited exclude short-term investments.

†*Ibid.*

‡*Trade Information Bulletin No. 746,* cited.

§Cf. *Alien Property Custodian Report* (Washington, 1919), pp. 9, 23. This does not include $34,000,000 of German vessels seized. Nor does the figure include credits granted after 1918.

‖Minus repayments.

Thus the Armistice found us in the nominally fortunate position of having European countries deep in our debt. Three-quarters of that debt, however, represented intergovernmental obligations held by the United States Treasury, and these have since proved impossible to collect.

POST-ARMISTICE LENDING ORGY

After the war there was still a strong demand for American loans to rehabilitate Europe and develop other parts of the world. A huge volume of bonds was publicly floated in this country by foreign national, provincial and local governments, and thousands of millions more of American money were invested in Europe, Latin America, Australia, Canada and the Far East. The lavish outpouring of our wealth continued until 1930.[4]

The investment history of this post-war period is summarized in the following figures:

	in millions
Net outflow on government capital account, 1919-1921	$2,107
Net outflow on private capital account through 1933, including net changes in short-term position	6,060
Gross increase in the creditor position of the United States, 1919-1933 inclusive, without allowance for depreciation or shrinkage	$8,167

With the intensification of the depression, foreign lending dwindled and all but disappeared. But capital outflow of a different sort continued, due to fear of currency depreciation in this country. Foreign banking funds in the United States declined from $870,000,000 at the end of 1932 to $487,000,000 at the end of 1933.[5] In 1934, following stabilization of the dollar, that movement was reversed; capital began to return in volume and much new money came in from abroad. In 1935 this movement reached its peak, most of the inflow representing short-term balances. In 1936, although the total inflow declined, new long-term investments by foreigners increased. The $792,000,000 of purchases by foreigners in our stock and bond markets represented the largest yearly inflow on record, and in magnitude actually exceeded private American long-term investments abroad in any year since the exceptional outflow of 1920. The net short-term inflow in 1936 was $397,000,000, a considerable decline from the $964,000,000 of such balances which came here in 1935.

We may now recapitulate the movement of capital on public and private account since 1914 as follows, noting that net changes in short-term balances are available only beginning with 1922:

	in millions
Private loans abroad, 1914-1933	$11,433
Government loans abroad, 1917-1921	9,535
Total outflow	$20,968
Net inflow, 1934-1936	3,064
Net outflow, 1914-1936	$17,904

While statistics on movements of short-term banking funds are available for the period since May 1929, detailed figures on all capital transactions have been collected only for the last two years

4. For statistics, cf. U.S., Department of Commerce, *Handbook of American Underwriting of Foreign Securities,* by Ralph A. Young, Trade Promotion Series No. 104 (Washington, 1930).

5. *Federal Reserve Bulletin,* May 1937, p. 399.

INTERNATIONAL CAPITAL MOVEMENTS OF THE UNITED STATES SINCE 1919*

in millions of dollars: Export (—); Import (+)

Year	Government capital account	Private long-term capital movement Inward	Outward	Net	Net short-term capital movement	Balance on capital account
1919	—1,781	515	891	—376	....	—2,157
1920	—240	571	1,400	—829	....	—1,069
1921	—86	303	974	—671	....	—757
1922	....	294	1,011	—717	+375†	—342
1923	....	435	434	+1	+3†	+4
1924	....	364	966	—602	+216†	—386
1925	....	551	1,038	—487	—61†	—548
1926	....	1,326	1,928	—602	+350†	—252
1927	....	1,609	2,332	—723	+900†	+177
1928	....	2,591	3,253	—662	—188†	—850
1929	....	2,328	2,464	—137	—80	—217
1930	....	2,161	2,428	—267	—485	—752
1931	....	1,520	1,301	+219	—709	—490
1932	....	862	645	+217	—409	—192
1933	....	1,505	1,456	+49	—385	—336
1934	....	1,160	958	+202	+184	+386
1935	....	2,009	1,547	+462	+1,075	+1,537
1936	....	....	....	+792	+329	+1,141

*U. S., Department of Commerce, *The Balance of International Payments of the United States in 1935* (Washington, 1936), pp. 82-83, and press release of March 8, 1937; also *The Balance of International Payments of the United States in 1936* (mimeographed), p. 6.

†These figures have long been recognized as faulty, but they have never been officially revised.

during which net foreign purchases of American securities have been heavy.[6] Of total capital imports amounting to 2,606.7 million dollars in 1935 and 1936, almost one-third—or 829.3 million—came from the United Kingdom. From Switzerland, France and the Netherlands also came large amounts—335.5, 299.5 and 229.7 million dollars respectively. Much smaller sums—83.1 and 45.6 million—were sent from Germany and Italy. Among extra-European countries, Canada contributed 150.5 million dollars, Latin America 199.6 million and the Far East 184 million. Figures on the origin of these imports are in part deceiving, however, because some of the funds transferred from leading European financial centers undoubtedly belonged to nationals of other countries.

A little more than half of the capital sent to this country in 1935 and 1936 was left in the form of short-term bank balances. A substantial portion—917.4 million—was invested in American stocks and bonds. There were particularly heavy purchases for British, Swiss and Dutch accounts. The last two years have also witnessed considerable repatriation of foreign securities held in the United States. Repurchases by the United Kingdom amounted to 116.1 million dollars, although part of this was probably effected for other countries. Germany repatriated directly 22.5 million dollars' worth of bonds previously floated in the New York market.

There have been several reasons for the unusual inflow of capital commencing in 1934, and their relative importance has apparently changed with the passage of time.[7] Economic and political uncertainty in Europe has undoubtedly been a major factor. After fear of the depreciation of the dollar had precipitated a flight of capital from the United States during 1932 and 1933, increasing monetary instability on the European continent brought about a reversal of this movement in subsequent years. The few remaining gold currencies—the French and Swiss franc and the Dutch guilder—were periodically subjected to great pressure, leading to heavy exports of capital and gold to London and New York. The dollar, formally devalued and stabilized in January 1934 at about 59 per cent of its former value, seemed particularly safe and impregnable to harassed European capitalists. Even after the depreciation of the Dutch, Swiss and French currencies in September 1936, doubt has persisted concerning the ultimate value of the French franc. In the case of France, the flight of

6. "Statistics of International Capital Transactions of the United States, May 1929-December 1936," *Federal Reserve Bulletin*, May 1937; also U.S., Treasury Department, *Statistics of Capital Movements between the United States and Foreign Countries and of Purchases and Sales of Foreign Exchange in the United States*, Reports Nos. 1 and 2 (Washington, 1936 and 1937).

7. Cf. *Federal Reserve Bulletin*, July 1936, p. 510-12; also Bank for International Settlements, *Seventh Annual Report* (Basle, May 1937).

NET CAPITAL MOVEMENT TO THE UNITED STATES DURING 1935 AND 1936*

in millions of dollars: minus sign indicates net export

Country	Total	Banking funds	Brokerage balances	Net purchases of American securities	Net purchases of foreign securities
United Kingdom	829.3	341.6	4.0	367.7	116.1
France	299.5	206.2	10.4	64.7	18.2
Netherlands	229.7	62.6	—.9	157.6	10.4
Switzerland	335.5	112.5	9.1	200.2	13.7
Germany	83.1	68.7	—.7	—7.5	22.5
Italy	45.6	39.3	0.3	—3.3	9.4
Other Europe	228.5	101.7	0.4	38.5	87.9
Total Europe	2,051.3	932.5	22.6	818.0	278.3
Canada	150.5	123.6	—7.6	32.6	1.7
Latin America	199.6	172.6	—4.2	15.5	15.7
Far East	184.0	120.7	2.1	44.1	17.0
All other	21.4	10.8	....	7.1	3.5
Total	2,606.7	1,360.3	12.9	917.4	316.2

*Compiled from *Federal Reserve Bulletin*, cited, May 1937.

capital was accelerated in 1936 by fears aroused by the "socialist" measures of the Blum government. Moreover, periodic war scares in Europe stimulated the flow of liquid funds to an ostensibly safe place of refuge in the United States. These factors, in addition to the gradual release of frozen funds, also brought about the repatriation of a considerable portion of American balances abroad. At the end of 1936 these had dropped to $657,000,000 from a total of $1,123,000,000 in 1934.[8]

The desire of many foreigners to participate in the profits of our economic recovery has seemed to some observers the most important single cause of the migration of capital to this country. American business revival was well on the way by the end of 1934 and has continued rapidly since that time. Observing the sharp recovery in production and in prices of securities and commodities, foreign investors anticipated an economic boom in the United States and eagerly rushed in to share its benefits. American stocks were bought in large amounts. In addition, the depressed prices for foreign bonds still prevailing on the New York Stock Exchange stimulated the repatriation of these securities. As a natural consequence of economic recovery, foreign banks also increased their working balances in this country.

There is less agreement as to the influence which the price now being paid for gold by the United States has had in attracting gold and capital to New York. Devaluation of the dollar raised the price of gold from $20.67 to $35 an ounce. Some authorities claim that at this value the American currency has been pegged too low in relation to the pound sterling and other currencies. In other words, they believe that capital will purchase more commodities, securities and services in the United States than in other countries and for that reason inevitably migrates to New York. Other observers, however, question this contention. While sometimes admitting that the dollar was initially undervalued, they claim that the rise in American prices and costs has practically offset the original low valuation. A comparison of British and American indices of wholesale prices and the cost of living does indicate that price structures in these two countries are in approximately the same relationship to each other as in 1929.[9] Since it is generally assumed, however, that sterling was slightly overvalued in 1929, the dollar may still be too low in relation to the pound. In the opinion of some experts, the apparent failure of the British Equalization Fund to change the prevailing sterling-dollar exchange rate indicates a conviction on the part of British authorities that these two currencies are not far from their true equilibrium.[10] Moreover, it is maintained that the American balance of international payments would tend to be extremely favorable to the United States if the dollar were actually greatly undervalued. Instead, the contrary appears to be the case. Whereas pay-

8. *Federal Reserve Bulletin*, May 1937, p. 399.

9. In 1936 the American wholesale price index was actually 5.4 per cent higher than the British when compared to the relationship existing in 1929. By February 1937 the difference had practically disappeared. When cost of living indices are compared in terms of gold, the British index averaged 9.1 per cent higher in 1936 and exceeded the American index by 6.4 per cent in February 1937. These figures were compiled from statistics in the *Monthly Bulletin of Statistics* issued by the League of Nations. It should be noted, however, that a comparison of wholesale prices or cost of living indices is not a completely adequate test of the relative value of any two currencies.

10. This failure to alter radically the dollar-sterling rate may also be due to Britain's deference to Washington's desires.

ments and receipts for goods and services still showed an export surplus of $208,000,000 in 1935, they yielded a net deficit of $132,000,000 last year.[11] Yet, while this evidence may prove that American and foreign commodity price levels have not been far from equilibrium, it does not affect the contention that prices of American securities have been relatively low compared to those prevailing in foreign stock markets. Those who believe the dollar undervalued maintain that, with the existing trade barriers, it has been simpler to sell foreigners securities than to increase our commodity exports.

ARE WE STILL A CREDITOR NATION?

The extraordinary flow of foreign capital to the United States has naturally raised speculation as to whether we are still a creditor nation. Some think that the rapid increase in foreign holdings of American securities and large-scale repurchases of foreign bonds originally issued in New York have made us a debtor country once more. According to a private calculation which has been given nation-wide publicity, American long-term investments abroad at the end of 1936 were down to $8,800,000,000 (market value), or $200,000,000 less than foreign long-term holdings here.[12]

These private estimates, it should be noted, are not accepted by experts who have studied the matter. They point out that, while it is undoubtedly true that in "portfolio" investments alone—i.e., securities—we are now a debtor nation on the basis of market values, this is not the case when "direct" investments are included and fairly appraised. In August 1936 Acting Secretary of Commerce Draper issued a special analysis to counteract "statements recently made which greatly underestimate the creditor position of the United States."[13] After referring to forms of misrepresentation and gross exaggerations in such private statements, Mr. Draper cited the Commerce Department's estimates of foreign long-term investments in the United States as slightly more than five billion dollars, and American long-term investments in foreign countries as $12,600,000,000, exclusive of war debts.[14] Including short-term balances here and abroad, but excluding outstanding credits extended by manufacturers and exporters, the net creditor position of the United States at the end of 1935 was given by Mr. Draper as "materially in excess of" $7,250,000,000. (The Department's calculation is shown in the accompanying table.) Despite the continued inflow of foreign funds in volume since 1935, as well as the appreciation which the rise in stock market quotations has brought to the value of foreigners' holdings in the United States, this country probably remains a net creditor by a considerable margin.

CALCULATION OF AMERICA'S NET CREDITOR POSITION AS OF DECEMBER 31, 1935

American holdings of foreign securities (largely bonds)	$4,800,000,000*
Direct investments abroad	7,800,000,000
American-owned bank balances and other short-term credits abroad as reported by banks and brokers	850,000,000
Total	13,450,000,000
Foreign holdings of American securities and other foreign investments in the United States	5,000,000,000†
Foreign-owned bank balances and other short-term funds owed to foreigners as reported by banks and brokers	1,200,000,000
Total	6,200,000,000
Net creditor position	$7,250,000,000

*Bonds and preferred stocks assessed at par value and thus considerably in excess of current market values.

†Probably appreciably higher at present market quotations.

It has often been said that the Commerce Department overstates the country's creditor position because of the methods it uses in computing the value of bond holdings and direct investments.[15] Attention is particularly called to the fact that American holdings of foreign bonds and preferred stocks are estimated on the basis of par values, rather than at depressed market prices. In reply, the Department offers another test of the country's net creditor position—the actual flow of money from the respective groups of investments:

"In its annual bulletin on the balance of international payments, the Finance Division of the Bureau of Foreign and Domestic Commerce reports the following itemized summary of the interest and dividend items in 1935.

11. Cf. U.S., Department of Commerce, *The Balance of International Payments of the United States in 1935*, cited, and *Federal Reserve Bulletin*, May 1937.

12. The Chemical Foundation, *"Hot Money" vs. Frozen Funds, The Deserted Village*, No. 12, reprinted in Extending Reciprocal Trade Agreement Act, *Hearings before the Committee on Finance*, U.S. Senate, 75th Congress, 1st Session, on H.J. Res. 96 (Washington, 1937), p. 253. This is the most recent of the Foundation's estimates of our financial position.

13. Statement by Ernest G. Draper, Acting Secretary of Commerce, relative to the Creditor-Debtor Position of the United States (mimeographed), Washington, August 13, 1936.

14. The estimates referred to by Mr. Draper were published in *Foreign Investments in the United States*, by Amos E. Taylor, Finance Division, Special Circular No. 417, June 5, 1936.

Receipts:

Interest on American holdings of foreign bonds	$188,000,000
Income from American-owned direct investments abroad	320,000,000
Earnings on American-owned short-term investments abroad	13,000,000
	$521,000,000

Payments:

Interest on foreign-held American bonds	22,000,000
Income to foreigners from direct investments in the United States	35,000,000
Dividends on foreign-held American stocks	63,000,000
Income to foreigners from other long-term investments in the United States	25,000,000
Payments to foreigners on short-term investments in the United States	1,000,000
	$146,000,000

"It is thus apparent that the actual receipts by the United States on its private investments abroad in 1935 exceeded corresponding payments by this country to residents of foreign countries on their investments in this country by a ratio of approximately 3½ to 1. Since the income on the short-term funds is comparatively small, this ratio is directly applicable to the holdings of stocks, bonds and other long-term investments. The importance of these figures as an index of the country's long-term creditor-debtor position is emphasized by the fact that the reported interest and dividend figures are largely based on the holdings of individual issues or the financial statements of individual companies. The income figures as computed are in large part independent of the data pertaining to the value of the investments, and are not subject to significant margins of error."[16]

15. The method of computation, and the nature of the criticism are described briefly in the following excerpt from Mr. Draper's statement, cited, p. 3: "In these figures all corresponding long-term assets and liabilities are computed on comparable bases. The investments of American concerns in plants and properties abroad which they directly control and the corresponding interests of foreign concerns in this country are shown at book values. All bonds and preferred stocks are reported at par, while miscellaneous (non-controlling) holdings of common stocks are shown on the basis of market values.

"By valuing bonds on a par rather than a market value basis, the creditor position of the United States is, according to one point of view, somewhat overstated. The reasons for this are, first, the market prices of foreign dollar bonds are considerably below par, and, second, the American holdings of foreign bonds, of which some are in default, are much larger than the foreign holdings of American bonds. It has been contended that the official estimate of American direct investments abroad is also overstated because of losses and write-downs which resulted from the world-wide depression. It should be noted, however, that substantial, and probably adequate, reductions in the official estimates have been made to cover such factors. However, because of the character of the respective assets, it may be true that if liquidating values could be used, the amount of American long-term assets abroad would be reduced somewhat more than that of foreign assets in the United States."

PROBLEMS CREATED BY THE IMMIGRATION OF CAPITAL

The recent changes in our net creditor position might, in the opinion of some observers, eliminate the need for readjustment of our commercial policy. Economists have often pointed out that the United States, as a large creditor nation, can expect payment of interest, dividends and principal on its investments only in goods, services or gold. A modification of our tariff and commercial policies was said to be necessary in order to bring about a so-called adverse balance of trade—an excess of imports over exports. During the past two years such an adverse balance has actually been developing. Whether this is a permanent change, it is too early to state. Meanwhile, the decrease in our net creditor position described above apparently tends to lessen the need for larger commodity imports.

So long as the "hot money" inflow does not permanently alter our creditor-debtor position, economists are justified in adhering to the view that we should have an "adverse" trade balance. To the extent that the capital movements are not temporary but represent real investment, the best test of our net creditor position for the purpose of determining commercial policy is to be sought in the direction of the net movement of funds representing payments of interest, dividends and other earnings on investments. This movement, on net balance, is still heavily in our favor. That is, our receipts of such interest, dividends and earnings are considerably in excess of our payments. It follows that, in our own best interest, we should receive these payments in the form of more goods and services. It is not to our advantage to receive service on our investments in the form of gold or silver, both of which are superabundant here.

It is occasionally suggested that the large volume of capital movements to this country clearly demonstrate that European countries can and should resume service on the war debts.[17] As is well known, these obligations are practically all in default. Only Finland and Greece are transferring payments.

The large scale on which capital has recently been sent to the United States does apparently indicate that the problem of transferring war debt payments—i.e., converting them into dollars—is not as formidable as it was once thought to be.

16. Statement by Ernest G. Draper, cited, p. 4. That the return from American investments abroad exceeds interest and dividends paid to foreigners is evidenced by the Chemical Foundation's own data, *Hearings before the Committee on Finance,* cited, p. 239.

17. Cf., for example, the remarks of Congressman Hamilton Fish, *Congressional Record,* May 10, 1937, p. 5160.

The argument is that, if so much capital can be transferred, why could not foreign countries meet the annual debt payments, which are much smaller? In reply, it may be pointed out that not all the capital entering the United States comes from nations which owe us war debts. A considerable part originates directly or indirectly in Switzerland, the Netherlands and other countries not indebted to our government. Moreover, the continuous flow of capital to the United States has been a source of serious embarrassment to some European countries. In France, for example, the flight of capital has created serious financial difficulties for the government and has generally retarded economic recovery.

It should also be remembered that the funds moving to the United States represent private capital over which governments have for the most part little or no control. To be sure, governments could prevent the emigration of the greater part of this capital by imposing drastic foreign exchange restrictions just as has been done by Germany. This course, however, presents so many serious disadvantages that most countries are reluctant to resort to it.

The bearing of capital imports on our commercial policy, and on the ability of foreign countries to resume war debt payments, is on the whole of minor importance when compared to the repercussions which the presence of "hot money" in the United States may have on our domestic economy. It is this problem which causes the Administration the greatest concern. Does not "hot money" increase the danger of uncontrolled inflation in this country? Would not the sudden withdrawal of this capital have a generally demoralizing effect on our economic life?

The continued investment of large sums of foreign capital in American stocks and bonds might be instrumental in bidding up stock prices beyond reasonable levels and thus generate a speculative boom with results as disastrous as those in 1929. Moreover, "hot money" makes our stock market much more susceptible than in the past to the influence of international and foreign developments. Factors over which the United States would have no control might intervene and precipitate a large-scale liquidation of foreign holdings. The ensuing break in securities prices would probably have an unfortunate psychological effect on American business. In the opinion of some experts,[18] however, the probability of a sudden withdrawal of foreign funds is remote. With improvement in Europe's political and economic situation, capital now invested here may be repatriated, but the process is likely to be slow. In the event of a European war, belligerent governments would probably assume immediate control over their citizens' foreign holdings and proceed to liquidate them gradually in payment for needed imports. Moreover, withdrawal would in all likelihood be preceded by a "period of warning," during which new foreign investments in the United States would be suspended.

Much more serious may be the ultimate effects of "hot money" on our credit structure. Large imports of gold have inevitably accompanied the inflow of foreign capital. In the three-year period 1934-1936, net gold imports amounted to $3,989,515,000. In the first four months of the current year, gold continued to come in at the rate of $1,835,000,000 per annum. The influx of this metal has created a perplexing problem by swelling the large volume of bank reserves on which our whole credit structure is based and thus aggravating the danger of credit inflation. Gold is imported by banks which sell it to the Treasury through the agency of the Federal Reserve Banks. The banks are paid in Treasury checks which are left on deposit with the Federal Reserve Bank concerned, and thus swell the reserves against which the bank selling the gold can lend funds to its customers. Until recently, member banks of the Federal Reserve system could as a group legally extend credit up to about ten times the volume of their reserves. The importation of about four billion dollars of gold during the last three years, therefore, created the basis for an enormous expansion of credit which would undoubtedly have led to serious inflation.

NET GOLD IMPORTS INTO THE UNITED STATES*

1934—	$1,133,912,000
1935—	1,739,019,000
1936—	1,116,584,000
1937—	
January	121,325,000
February	120,326,000
March	154,332,000
April	215,811,000
May	155,362,000

*U.S., Department of Commerce, *Monthly Summary of Foreign Commerce of the United States,* December 1936, January to March 1937 and press statement of June 12, 1937.

To offset the effect of gold imports on bank reserves, the Board of Governors of the Federal Reserve System twice raised legal reserve requirements. Acting under authority given by the Bank-

18. Cf. Marcus Nadler, "Possible Effects on the United States of a European War," *Digest of Digests,* January 1937 (published by *Monthly Stock Digest Service*); and Herbert M. Bratter, "Complications Involved in the Administration's Efforts to Curtail 'Hot Money,' " *The Annalist,* March 5, 1937.

ing Act of 1935, the Board decided on July 14, 1936 to increase reserve requirements by 50 per cent, effective on August 15.[19] While this action reduced excess reserves—i.e., reserves above legal requirements—from $3,167,000,000 on August 12 to $1,813,000,000 one week later, the total had again risen to about $2,160,000,000 by the end of January 1937. On January 30, 1937 the Board ordered another increase of 33⅓ per cent, one half to become effective on March 1 and the remaining half on May 1.[20] On May 5 excess reserves were down to about $890,000,000.

The balance of excess reserves would have been much greater had not the American government also adopted a policy designed to "sterilize" further gold imports. On December 21, 1936 it was announced that henceforth the Treasury would buy gold with proceeds from the sale of public-debt obligations and hold such gold in an inactive account in the general fund. This new policy implied that gold imports would no longer be permitted to swell bank reserves. By June 10, 1937 the Treasury had in this way bought gold to the value of $896,110,032.

By these two methods—raising reserve requirements and "sterilizing" gold—the government has so far been successful in offsetting the potential inflationary effects of the influx of gold. Reserve requirements have now been lifted to the maximum permitted by law, so that further action along this line would require Congressional authorization. Moreover, this policy has thrown the burden exclusively on the banks by diminishing their supply of loanable funds. To raise reserve requirements further might drive banks out of the Federal Reserve System. "Sterilization," on the other hand, costs money. If gold has to be acquired by the Treasury at the same rate as in the last few months, it will involve an increase in the public debt of over $1,898,000,000 a year. Such an increase is particularly embarrassing at a time when the government bond market is manifesting growing concern over continued budget deficits. Moreover, the interest charges incurred on this debt run counter to the Administration's desire to economize as far as possible. The gold bought by the Treasury might, of course, be coined and put into circulation, but this would mean restoration of convertibility of the dollar at a fixed rate in terms of gold—a step for which the Administration is not ready. The government therefore appears anxious to devise new methods of dealing with the "hot money" problem.

19. *Federal Reserve Bulletin,* August 1936.

20. *Ibid.,* February 1937.

NEW METHODS OF DEALING WITH HOT MONEY

Measures designed to stop and even reverse the present importation of capital and gold would probably be more desirable than those which seek merely to counteract possible harmful effects of such an inflow. Even if measures of the latter type are successful, they do not eliminate the necessity of incurring public expense in sterilizing and storing surplus gold. Such expenditure is particularly undesirable since our present monetary gold stocks are more than adequate to meet any emergency.

Nevertheless, the objective of checking the immigration of capital and gold is not easy to achieve. It has been pointed out that the imposition of additional taxes on foreigners might make our securities a much less attractive investment. At present non-resident aliens who make profits in our market are not subject to a capital gains tax. According to Marriner S. Eccles, Chairman of the Federal Reserve Board, this is manifestly unfair.[21] When it is proposed, however, to tax more heavily dividend and interest payments to aliens, and to restore the capital gains levy on foreigners which was abandoned in 1936, many difficulties immediately arise. It is not a simple matter to increase the tax on income of foreign nationals, since care must be taken to avoid the charge of discrimination. According to current international practice, a country may not tax foreigners more heavily than it taxes its own nationals. The present withholding tax of 10 per cent on payments to non-resident aliens is a moderate one, but for the above reasons it is doubtful whether it could be increased sufficiently to deter foreigners from investing in our market.[22] There would be an additional difficulty in the case of Canadians, because on December 30, 1936 we concluded a convention with our northern neighbor providing that the withholding tax applicable to Canadian residents be reduced to 5 per cent.[23] Moreover, a heavier withholding tax, or even a capital gains tax, would not affect the short-term bank balances kept here by foreigners.

21. Address before the Seventh New England Bank Management Conference, November 13, 1936.

22. The withholding tax of 10 per cent is a uniform tax withheld at the source on all recurrent items of income such as dividends, interest and rents paid to non-resident aliens. Foreigners have claimed that this tax is heavy, being equal to that paid by Americans with total incomes of $25,000. This remonstrance, however, ignores the freedom of foreigners from a capital gains tax.

23. U. S., Department of State, *Treaty Information Bulletin No. 87,* pp. 14-15. Our law provides that the 10 per cent withholding tax may be reduced to 5 per cent in the case of residents of a contiguous country, in the event that provision for such reduction is effected by treaty with such country.

The capital gains tax on non-resident aliens who have no place of business in the United States was abandoned in 1936, on the ground that it was extremely difficult to collect. The United States has no jurisdiction over non-resident foreigners and under present circumstances cannot force them to declare their profits on security transactions. Even if this technical obstacle were removed, there would still be numerous legal loopholes and other technical devices available to well-informed investors abroad. To block these would involve a great administrative problem. Nonetheless, if the "hot-money" problem is not otherwise solved, the restoration of a capital gains tax remains a possibility.[24] A further complication is the rather widespread opposition by Americans to the principle of domestic capital gains taxation.[25]

That heavier taxation on non-resident foreigners is a possibility was indicated in President Roosevelt's message on tax evasion submitted to Congress on June 1, 1937. In a letter incorporated in this message, Secretary of the Treasury Morgenthau declared that "the present taxing provisions are not satisfactory as applied to non-resident aliens in the higher brackets." Specifically he held that "the withholding rate has proved in practice to be too low. . . ."[25a]

Since European countries are as anxious to check capital exports to the United States as we are, it may prove possible for Washington to cooperate to this end with other governments. The latter are perhaps in a better position to deter such capital movements by moral suasion, threats of taxation and other measures. To facilitate financing of its rearmament program, the British government is trying to discourage the outflow of capital.[26] The United States might encourage such measures and cooperate with other countries to check tax evasion, violation of exchange control laws and other restrictions on foreign investments. It may be doubted, however, that this would make a substantial contribution to the solution of the "hot money" problem.

In theory it might be possible to obviate the gold imports which have accompanied the influx of capital into this country by greatly increasing our purchases of foreign goods and services. On examination such a policy seems wholly impractical It would have necessitated over the past few years additional imports of several billion dollars which probably would have been ruinous to American industry and agriculture. The United States can hardly be expected to adjust its trade to the constantly fluctuating volume of international capital movements. To be sure, we could offset the influx of capital by renewed foreign lending of our own, but Americans are unlikely to invest money abroad so long as foreigners themselves see better prospects for profits and greater safety for their capital in the United States.

In so far as political and economic instability abroad has contributed to the flight of capital to our shores, any steps leading toward improvement of such conditions in Europe would help to solve the "hot money" question. A detailed discussion of the contributions the United States can make toward international economic and political appeasement does not come within the scope of this report. It should be noted, however, that the American government appears ready to collaborate in the extension of international trade and the attainment of monetary stability. At present, uncertainty concerning budget and price developments in certain countries, and the difficulty of dealing with "controlled" currencies like the German Reichsmark, remain among the major obstacles to currency stabilization on a sound basis which might minimize the restless migration of capital.

REDUCTION IN THE PRICE OF GOLD?

Some who believe that undervaluation of the dollar is largely responsible for the continued gold inflow advocate a reduction in the price of gold by the United States as a logical method of solving the problem. In their opinion, this country is bound to continue to absorb a considerable portion of the world's increasingly large gold production and supplies so long as we are prepared to pay $35 an ounce for this metal in unlimited quantities. According to this group, the dollar is actually undervalued.[27] As indicated elsewhere,[28] the validi-

24. For a lawyer's views as to this general problem, cf. Montgomery B. Angell, "The Non-Resident Alien: A Problem in Federal Taxation of Income," *Columbia Law Review*, June 1936. For information on the present withholding tax, cf. U.S., Treasury Department, Bureau of Internal Revenue, *Bulletin N, Income Tax, Revenue Act of 1936* (Washington, 1936).

25. Cf. "Capital Gains Tax Repeal is Urged by Fiscal Expert," Associated Press interview with former Undersecretary of the Treasury, Arthur W. Ballantine, *Washington Post*, May 11, 1937. On May 20, 1937 Congressman Emanuel Celler of New York introduced a bill calling for repeal of the capital gains tax (H.R. 1572).

25a. *New York Times*, June 2, 1937.

26. Certain measures recently taken by the British authorities have had as one apparent purpose the deterring of capital movements to the United States and elsewhere. The most conspicuous of these was the reported request of the British government to insurance and investment companies to avoid unnecessary foreign investments. (*New York Times*, February 25, 1937, and *New York Herald Tribune*, February 24, 28, 1937.) How important a contribution to our "hot money" problem this may be it is still too early to learn from published data on capital movements.

For discussion concerning the tightening of the foreign loans embargo and its connection with British rearmament, cf. Robert Benson and Co., *Monthly Review*, April 13, 1937, p. 2.

ty of this opinion cannot be adequately tested. It is necessary first to define "undervaluation," and second to find a means of measuring it. At any rate, the administration has on several occasions denied that it plans to cut the gold-buying price.[29] If adopted by the United States alone, such a course might well entail serious disadvantages. It would disturb the tripartite monetary understanding reached last September unless the step were taken after consultation with France, Britain and the other nations which have since adhered to the accord. The existing relationship between the dollar and foreign currencies would be upset, so that other countries would once more face the question whether or not to revalue their monetary units. Moreover, if the United States alone cut the price of gold, it would tend to depress the prices of American goods sold in the world market and might have a general deflationary effect. While, from the economic point of view, gold and commodity prices are no longer closely connected, the two are psychologically linked in the eyes of the general public, so that a lowering of the gold price might cause a decrease in commodity prices generally, which in turn would affect business unfavorably.

Even though unilateral action by the United States may be inadvisable, an international agreement providing for all-round reduction in the price of gold may prove feasible and desirable. The depreciation and devaluation of almost all currencies has brought about a substantial increase in the price of gold everywhere. At the same time the cost of mining gold has risen much more slowly, so that production of this metal has been enormously stimulated.[30] From 1929 to 1936 the output increased 81 per cent in volume and 206 per cent in terms of dollars. In addition, the high price of gold led the Far East to dehoard a large quantity of the metal—estimated at about 42 million ounces for the last six years.[31] All this gold has had to be absorbed and, as the most acceptable and available medium for the transmission of "hot money," it has naturally gravitated to places affording the maximum degree of security. At present world gold stocks, although very unevenly distributed, are in the aggregate far more than ample, especially since gold no longer circulates internally as currency but is used almost solely for the settlement of international accounts. The plethora of gold is especially embarrassing to the United States and, to a lesser degree, Britain. Both are reluctant to have it enter into bank reserves at its current valuation and are accordingly compelled to sterilize it at the expense of increasing the public debt.[32] The absorption of a large part of current gold output by the United States actually means that this country is liberally subsidizing producers of gold in the British Empire—South Africa, Rhodesia, Canada and Australia—who together accounted for almost half of world production in 1936. The presence of a substantial amount of foreign capital in the United States also suggests that we are compelled to shoulder the expense of holding gold reserves which in reality belong to other countries.

GOLD PRODUCTION, VALUES AND GOLD RESERVES

	World Gold Output		*Gold Reserves*	
Year	*Volume*[1] *(millions of fine ounces)*	*Value*[2] *(millions of dollars)*	*(in millions of dollars)* *World*	*United States*
1929	19.7	397	10,166	3,900
1930	20.7	432	10,675	4,225
1931	22.4	461	10,970	4,051
1932	24.3	498	11,540	4,045
1933	25.5	525[3]	11,529	4,012
1934	27.6	958[4]	21,051[4]	8,238[4]
1935	31.0	1,050[4]	21,583[4]	10,125[4]
1936	35.3	1,165[4-5]	22,663[4]	11,258[4]

1. Bank for International Settlements, *Seventh Annual Report,* cited, p. 37.
2. From Director of the Mint, *Annual Report,* 1936. Calculated at $20.67 per ounce prior to 1934, and $35 thereafter. It will be noted that the volume and value figures come from different sources and thus contain small discrepancies.
3. Equivalent to $889,000,000 at $35 an ounce.
4. At $35 an ounce.
5. Preliminary; from *Federal Reserve Bulletin,* May 1937.

Presumably it would be possible to lower the price of gold within the framework of the tripartite monetary understanding without disturb-

27. The influence of devaluation on foreign investment in the United States is recognized in the *Federal Reserve Bulletin* of July 1936, p. 511.

28. Cf. pp. 81-82.

29. Cf. the President's statement in his press conference of June 4, *New York Times,* June 5, 1937.

30. Cf. John J. Croston, "Effect of Revaluation on the Gold Mining Industry," *Technical Publication No. 709* (New York, American Institute of Mining and Metallurgical Engineers, February 1936); also "New Sources of Gold Production," *Barron's,* May 3, 1937. It is doubtful, however, that the high price of gold has been a primary factor in the great rise in Soviet output from an estimated total of 1,085,000 fine ounces in 1929 to about 7,350,000 in 1936. For these figures, cf. Bank for International Settlements, *Seventh Annual Report,* cited, p. 39.

31. Bank for International Settlements, *Seventh Annual Report,* cited, pp. 40-41.

32. Indicative of the altered position of gold is the attitude of the central banks of Finland, Sweden and Norway, which hold only part of their gold as monetary reserve. The remainder is regarded as secondary cover, and in Norway is specifically labelled "funds placed temporarily in gold." (Cf. Bank for International Settlements, *Seventh Annual Report,* cited, p. 64. Cf. also letter from Hans R. L. Cohrssen on Sweden's monetary policy, *New York Times,* May 22, 1937.) Any step toward lowering the price of gold in one of the Scandinavian countries would influence the attitude of the United States on this matter. (Cf. "London Sees Peril in Sweden to Gold," *New York Times,* May 17, 1937.)

ing existing exchange ratios. Theoretically, such action should not be attended by unfavorable deflationary effects. Actually, however, there might be a reaction in prices, particularly if the step were popularly regarded as minimizing the danger of inflation. Opposition to international reduction in the gold price may be expected from the British dominions whose gold miners have profited from the present "subsidy" and for some of whom the metal constitutes an important item in the balance of payments. If the price of gold were lowered, moreover, countries would be deprived of part of the actual or potential profit which national treasuries have harvested or expect to obtain on revaluing monetary gold stocks after formal devaluation of currencies. The United States Treasury, for example, would forfeit part of the profit of about $2,800,000,000 obtained through revaluation of American gold reserves in January 1934. Yet despite this disadvantage, sentiment for a cut in the price of gold appears to be growing. In its last annual report, the Bank for International Settlements took special cognizance of the suggestion and commented upon it as follows:[33]

"It has also been suggested that the price paid per ounce of gold should be lowered from the high figures to which it has risen in terms of depreciated currencies; in that way the amount of monetary purchasing power produced by a given weight of gold would be reduced, and a restraining influence would also be exerted on the output of gold, for gold mining would become less profitable. It can hardly be doubted that at present a lowering of the price of gold would help to cope with the serious problems resulting from the over-abundant production. It would, however, cause certain difficulties with regard to valuation of existing gold reserves and the relative position of currencies (the latter, in so far as equilibrium has already been attained, should be disturbed as little as possible). It would, moreover, involve the danger of manipulation of currencies in the future, which would add an element of instability and distrust to the monetary structure."

The disadvantages of reducing gold production indirectly, by lowering the price, have led to the alternative suggestion of a direct limitation on output by international agreement. Such an accord, however, would be very difficult to conclude, particularly since it must include all the gold-producing countries.

CONCLUSION

The tremendous capital movements of recent years are a result of the highly unsettled political and economic conditions which have prevailed throughout the world. Their roots go far back and no single date or place can be marked as their point of origin. Government policies adopted here and abroad, changes in business conditions, fear of war, all have contributed at times to the movement. The cheapening of the United States dollar in 1933, the gold price adopted by this country in 1934, and the silver buying policy of the American Congress have contributed heavily to the movement by making available to foreigners vast quantities of dollars which would otherwise not have been available.

The arrival of foreign funds in huge volume has given rise to fears of inflation in this country. It has been a major consideration in the formulation of the anti-inflationary measures thus far taken in Washington: the raising of reserve requirements and the sterilization of gold. It has beyond doubt influenced our stock market, and its "tentative" presence here continues to be an unsettling factor. This unprecedented movement of liquid capital since 1933 has complicated the problem of international currency stabilization and of internal currency management.

The "hot money" question cannot be easily solved. For the several countries concerned to control capital movements directly means a step backward to exchange control. For us to check the inflow by taxation is, for various reasons, most difficult of realization. A change in the price of gold would be partially effective, but there are practical complications. Simply to wait until "natural developments" cause a cessation of the movement, as in fact we have been doing for three years, involves continued inconvenience, expense and even risk. The problem of orderly withdrawal of the foreign capital already here would still remain a source of potential trouble. Since there is no simple solution for the problem, the attitude of official Washington seems to be one of watchful waiting. No outward sign of a change in the present attitude has been given. Certain observers, however, feel that, sooner or later, some official action within the tripartite understanding will be taken.[34] In essence, the whole problem is international rather than national. The flow of capital to the United States is in large part attributable to factors with which this country cannot cope alone.

33. *Seventh Annual Report*, cited, p. 56.

34. In the May 5, 1937 issue of the Bulletin of the National Association of Purchasing Agents (New York), Professor H. Parker Willis states that "a gold situation has been created which in the nature of the case is intolerable and cannot be permitted to endure indefinitely . . . the problem can apparently be depended upon to grow worse as time passes."